

HISTORICAL FINANCIAL FLOWS COMPARED WITH THE ACTUAL FINANCIAL CRISIS

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Today in the global economy the importance of financial systems is more vulnerable than ever. To understand the situation and to find a solution for the current instability sometimes is good to look back in the history in order to find alternatives for avoiding or preventing the crisis. The focus of this paper is the analysis of the financial and debt crisis in small economies provoked from big economy actions through the history, and their repeating in the present. The main objective is to set a model which shows that economic circles are leaking. The research results are presented in a consistent form. The conclusion emphasizes once again that the history comes again today, and that the present financial situation should be anticipated.

Key words: *financial crisis, financial alternatives*

The historical data show that big increases of the budgetary debt are mostly led by sudden decreases of the tax of gain and usually because of the big undertaken actions in the government spending in order to fight down the recession, the commercial costs are, in some cases relatively minor reason for post-financial crisis debt weights, and some of the financial crisis are called systematic financial crisis. Still, the modern financial crisis is severe to any measures. The last empirical researches focus on alternative evaluations of the crisis, especially on the crisis of the cash flows. Some authors, such as Frankel and Rose use a range of 105 countries for the period from 1970-1991 to conclude that the current account has no meaning in the crisis explanation. The authors Kaminski and Reinhart include implicitly the connection of the current account and the crisis of the cash flows including the rate of export and import growth in their analyses. These authors take the export-import rate as a relevant

factor for early warning of crisis. The warning is based on noise – to – signal ratio of the series being analyzed. Edwards’ analysis, on the other hand, shows that under some crisis definitions and partial exclusion of the African countries, the deficits of the current accounts are significant determinants for the probability of experiencing crisis. Razin and Rubinstein are focusing on the oscillation of the real monetary course to define the crises. Up to the point that many recent crises were started through credit shocks on the international markets, the crises measurement is more connected with the size and unexpected transactions of the capital account, than with the size of the fluctuation of the nominal cash flows or the current account turnover. Actually, the current account and the movement of the currency rate can be more influenced by the endogenous social decisions than the systemic sudden stops – 3S. Systemic sudden stops means big and much unexpected contractions of the capital account that appear in periods of systemic turbulence and the importance of the effects on the balances and their materialization¹. The systemic sudden stops are caused by numerous and big exogenous aggregate expansions and rate interest influences. Thus, the systemic sudden stops can appear in a partly different crises timing comparing to the currency rates or the capital account turnover.

According to Radelet and Sachs, the financial crises can appear when there is a sharp overturn (decrease) in the net private foreign capital flows. With this definition, they do not aim to underline the “unexpected” component in the sudden stops and do not discriminate if the crises episodes are domestic or foreign. An indicator of the sudden stops can also be focused on the overturns of the capital account that coincides to a big increase of the aggregate expansions. This indicator is taken in consideration based on the need of

¹ NBER Working paper 14026 – Guillermo A. Calvo, Alejandro Izquierdo, Luis – Fernando Mejia, “Systemic Sudden Stops: the Relevance of Balance – sheet Effects and Financial Integration”, National Bureau of Economic Research, Cambridge, May 2008, p.1

précising the crises connected with an extern stimulation, and the extern stimulation is systemic by nature, e.i. it refers to the systemic sudden stops. We should take in consideration that this defining of the 3C overturns of the capital account coincide with the decrease of the output, so there is a decrease of the influence of the domestic factors in the definition, which provides a focus on the extern background.

Rothenberg and Warnock join Calvo, Izquierdo and Mejia in 2006 to explore the differences between the capital account turnovers originating from the capital flows transactions and their attribution to not residents vis a vis those attributed to residents. As the case in Chile, where most of the capital account balance changes are caused by the changes of the brut flows strengthened by the residents. For the limited example of countries, they discovered that many of the capital flows net turnovers are due to transactions executed by foreigners. The next direction of this paper revises the crises initiated by foreign reasons. The terms big and unexpected are very significant and central for the sudden stops. Several conditions encounter the sudden stops in order to operationalize then and to look them as a phase. Those conditions are²: The stops consist at least one observation where year by year the decreases are relying on at least two standard deviations under the example (this refers to the “unexpected” sudden stop); The sudden stop phase ends when the yearly change of capital flows overpasses one standard deviation under the example. This will generally introduce consistency, which is a general fact about sudden stops; Furthermore, for the will of symmetry, the beginning of a sudden stop phase is determined by the first time of yearly change of decreased capital flows for one standard deviation under the example. Because of this, the sudden stop phase starts by

² NBER Working paper 14026 – Guillermo A. Calvo, Alejandro Izquierdo, Luis – Fernando Mejia, “Systemic Sudden Stops: the Relevance of Balance – sheet Effects and Financial Integration”, National Bureau of Economic Research, Cambridge, May 2008, p.11

decreasing capital flows that overpass the standard deviation and are followed by the fall of two standard deviations, the process will last until the capital flows change is bigger than minus one standard deviation. This crises concept pretends including episodes that otherwise would not be qualified as crises when used as threshold measurements of current accounts' fix deficit. In addition to this, later on many of the crises in the developed countries would be excluded simply because their variability and inconsistency is smaller. Monthly data are used to maximize the exact possibilities for timely discovery of the sudden stops episodes because of the data with smaller participation that can blur the beginning of the episodes. Determination of the exact timing of these episodes is relevant because of the fact that the eventual changes of the real currency rate that can emerge from the potential closure of the current's account deficit should be measured *before* the sudden stop taking place. If we consider that the information of the capital account of this type of interval (monthly) are unavailable, we get a construction of a capital flow approximate to the net trade balance from the changes in the foreign reserves. The changes of the 12 months cumulative measures of the capital flows are taken approximately on a year basis in order to avoid the season fluctuations. If we continue with the statement that systemic unsudden stops (3C) or unsudden stops should be identified through hexogen defiant, in addition we have to look the discovery of unsudden stops that have periods of sudden increase of aggregate expansion. Thus, it is underlined that the big discovered changes in the capital flows are used for aggregate expansions, in order to discover the periods of turbulence of the capital market. This type of analyses are made on 110 countries (21 developed economy and 89 countries in development for a period from 1990 2004)³.

³ NBER Working paper 14026 – Guillermo A. Calvo, Alejandro Izquierdo, Luis – Fernando Mejia, “Systemic Sudden Stops: the Relevance of Balance – sheet Effects and Financial Integration”, National Bureau of Economic Research, Cambridge, May 2008, p.13

As we mentioned earlier, the actual financial crisis that begun in 2007 and still lasting, it is predicted to take the biggest proportions known in the history of economy. Not only for that reason, but because the crises are repeating, it's important to respond the question who is causing the crises, how are they are predicted, when and if they can be stopped and where does the regulation find its place in these responds. Many accusations about the actual crisis and the reasons for its appearance are also connecting with the political background, especially connected with the presidential elections in America in 2008. The critics go especially to the republicans in America because of the support of the bank deregulation they considered to be necessary at that time due to the growth of the American economy. In 1999, an act was woted, known as "Gramm-Leach-Bliley Act", which terminated the positions of the previous act, „Glass-Steagall Act“. Glass-Steagall Act is a part if the legislative of the big depression era that introduces and defines a number of regulations of the financial institutions. This act is adopted with compromise from both American parties. Still, it is considered that this act from 1999 didn't cause the crisis, but on the other hand, it makes the crisis less rough and difficult than otherwise. The FED board that provided a dangerously speculative economy is considered to be more significant agent for the crisis. In 1998 it is decided that the commercial banks can undertake activities and from the investment banking when Citicorp regulators (commercial bank) let them to participate in the Traveler's group (insurance company that was partly included in investment banking) and these two companies to form together Citigroup. With this act of the regulators it was actually announced the change of Glass-Steagall Act. As a reaction to this thesis appears the attitude that besides this, the deregulated banks are not the biggest offender for the current debacle. In time, Bank of Amerika, Citigroup, Wells Fargo and J.P.Morgan can thoroughly repair the financial crisis (if they are not attacked by it as well) and still exist on the market. Bear Stearns and Lehman Brothers were the institutions that stayed

independent despite the abolition of Glass-Steagall Act, and one of them collapsed, the other bankrupted. Even the deregulation was the reason that provided Bank of Amerika and J.P.Morgan to gain and buy Merrill Lynch and Bear Stearns, which allows them to fight better with the financial crisis and its consequences. However, the regulation infiltrates its components into the reasons for a beginning of the crisis from 2007. Currently, it has been especially revised the Federal Housing Enterprise Regulatory Reform Act from 2005 that turns to a unique independent regulatory body, the legislative for reorganization of the precaution and the supervision and independent agency for regulation of the two selected entities.

If we take a different perspective, a place in the guilty list for the current crisis can also be appointed to the Federal reserve, domestic (American) buyers, the Congress, real-estate agents, Clinton's administration, mortgage brokers, Alan Greenspan, Wall Street companies, Bush's administration, unclear accounting rules, collective delusion. If we add the attitudes stating that the most guilty ones are the greedy participants of Wall Street, a big part of the guilt automatically comes down to the regulation which is especially weak in the part of the American mortgage market. The crisis from 2007 is also called failure "sinking in the frames of Titanic" for the regulation. Alan Greenspan, who ones held the title and reputation of an economist with a sense for the market conditions, now is numbered in the agents causing the crisis exactly because of the oversight he did with the regulation. He declares that "the borrowers are capable to evaluate on their own the risks of individual applicants" by which he only confirms his faith in the market forces and the unnecessary investments. Through Home Ownership Protection Act, FED was given authorization for regulation of the mortgage loans as well. Here the regulation and its minimalism are appearing as an agent of the crisis from 2007. Since Ben Bernanke has stepped as the head of FED, certain changes have been made in the regulative

measures with so-called “Regulation Z” that reply on the demand for a documentation to confirm the capability of the loan demanders to pay the debt.

What are the proportions of the regulation during the expansions of the crisis in the other countries? For example, if we take England, a country with relatively stable financial system and a last banking downfall marked in 1878 when City of Glasgow Bank and West of England & South Wales District Bank bankrupted, there is a question why this kind of system endures a dramatic fall or is that a question of implemented and present instability of the whole system. Even in this kind of system, the incompetence and the inadequacy of the regulation, as well as the poverty of the public elections lead to financial crises. Low interest rates followed by “unjustified” confidentiality in the economic system lead to systematic underrated risk. The entire situation and the permission for Fannie Mae and Freddie Mac to buy 44% of all high risk securities made the regulation not reacting effectively. Since 2002, in this country it is accentuated the little attention that Financial Services authority commits to the systematic risk. This is not caused because of the fact that the regulation of England is weak, it has even been estimated that the directing to the aspect of systematic risk costs 50% less than what was predicted, still the focus was put on concrete points, for account of the wider ensemble and the stability of the entire financial system. The internationality of the regulation shows a moment of copying during the behavior. If the rules direct everyone to the same activity, then the reverse effect of the diversification makes the crises more similar and dangerous when they occur. The regulation of short-term hedge funds makes things more difficult for the banks because it directs them towards convertible bonds.

The conclusion would be that the crises were and will be present. To answer the question where is their source we should look in several locations and act in the frames of the real and possible. Every single activity should be founded on real bases, but every single regulation should also be possibly

executable. The regulation has a big part in the beginning of the financial crisis. This part is not unique, but it's enough important so that can be marked with implications for creating and developing circumstances favorable for development of a crisis or at least, disturbing the financial system.

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